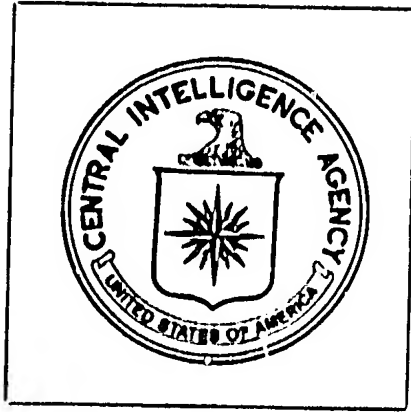


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Sri Lanka: Unaffordable Socialism

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SRI LANKA: UNAFFORDABLE SOCIALISM

SUMMARY AND CONCLUSIONS

1. Sri Lanka is a no-growth welfare state, which until recently could get by with minimal foreign assistance. This situation is changing, in part because of Colombo's chronic neglect of its key agricultural sector, in part because of the higher costs of imported oil and grain.

2. Output from tree crops -- tea, rubber, and coconuts -- which provide 75% of export earnings, is declining under the pressure of government takeovers, a discriminatory exchange rate system, and heavy taxation. Rice production, which increased steadily during 1965-70, has failed to increase further since 1970. The country's heavy dependence on imported grain and petroleum and its inability to expand exports have forced stringent controls on nonfood imports and an increased reliance on short-term foreign loans.

3. Prospects for sustained economic growth are poor. Foreign investors are effectively locked out by government policy, and domestic investors are discouraged by constraints on private economic activity. The government shows no signs of shifting toward growth-oriented policies. Failure to generate growth has worsened widespread unemployment and has eroded welfare programs. The attention of the Sri Lankan government remains focused on its hosting of the 1976 nonaligned countries conference and on the national elections slated to be held before mid-1977. Because of these factors, Colombo is likely to depend upon increasing amounts of foreign assistance simply to maintain welfare programs. Failure to maintain these programs will increase the likelihood of political instability.

Note: Comments and queries regarding this publication are welcomed. They may be directed to [REDACTED] of the Office of Economic Research, Code 143, Extension 6202.

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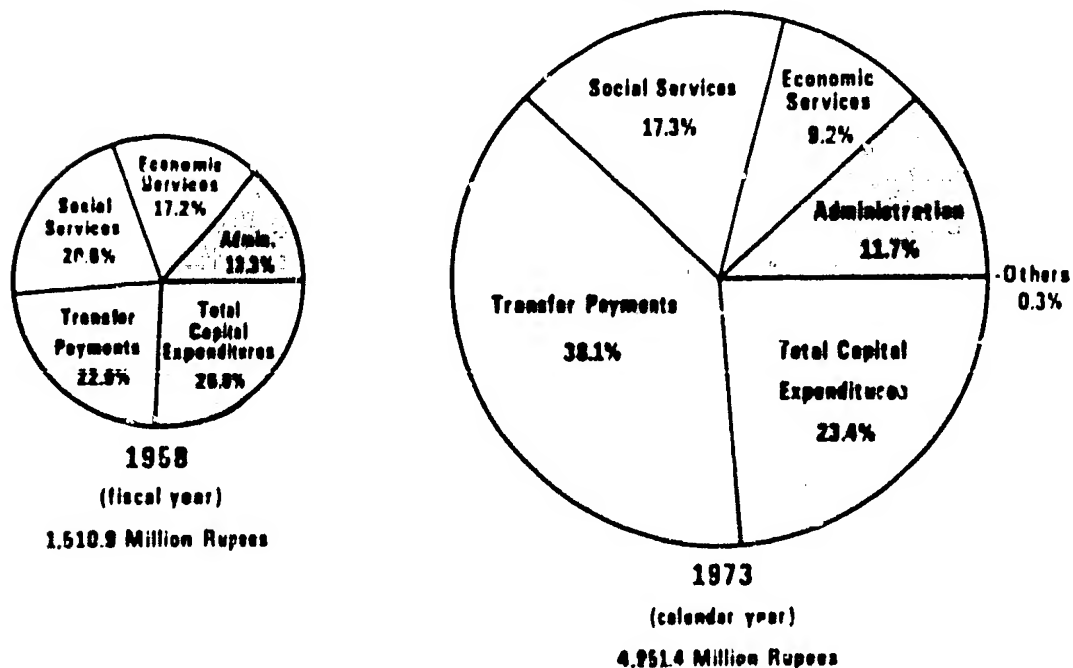
DISCUSSION

Policy Orientation

4. Sri Lanka has maintained a strong policy orientation toward development of a socialist-welfare state inherited from the British. All major political parties share this basic orientation, and debate centers on how fast and how far change should go. Twenty-five years of welfare policies have increased the transfer payments share in the government budget. For example, they grew from 23% to 38% of total government spending between 1958 and 1973 (see Figure 1). These transfers include

**SRI LANKA: Distribution of Government Spending,
1958 and 1973 (In percent)**

Figure 1



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financing free rice, other consumer subsidies, and government pensions. Although domestically obtained revenues financed 70% to 80% of the welfare-style budget in recent years, foreign aid is now increasing sharply. It is projected to meet half of Sri Lanka's 1975 budget deficit of \$200 million.

5. The government has successfully redistributed income. Between 1963 and 1973 the share of income earned by the top 20% of income earners fell from 55% to 46% and the share of the bottom 50% rose from 17% to 22%. The main impetus for redistribution came from wage adjustments for the lowest paid workers, heavy taxes on high income and wealth, and land reforms.

6. These programs have contributed to slower growth, encouraged emigration of businessmen and professionals, and increased unemployment and underemployment. At the same time, welfare programs have provided extensive educational and health services and minimum food supplies. Priority for transfer payments and social welfare programs, however, has restrained government outlays for capital investment in development projects such as irrigation while socialist policies restricted private enterprise. As a result, per capita income growth has stagnated and about one-third of the labor force is unemployed or underemployed. Unemployment hits well-educated young people the hardest; about two-thirds of the unemployed are educated beyond the ninth grade. While welfare programs ease the burden of the unemployed, failure to stimulate new growth and generate new jobs remains a continuing threat to political stability. This will be particularly true if welfare services have to be reduced. Widespread youth-centered unemployment was a contributing cause of the 1971 insurrection, which nearly toppled the government.

Agricultural Stagnation

7. Sri Lanka's economic structure has not changed significantly in the past 50 years. The country remains an exporter of tree crops -- tea, rubber, and coconuts -- and an importer of grains and manufactures. The output of tree crops, which accounts for about three-fourths of export earnings, has generally failed to grow for a decade (see Figure 2). Rice production has consistently fallen far short of domestic needs, and Sri Lanka relies on rice and flour imports for about half of its consumption

(see Figure 3). Food imports, mainly rice, wheat flour, wheat, and sugar, accounted for 48% of imports in 1974.

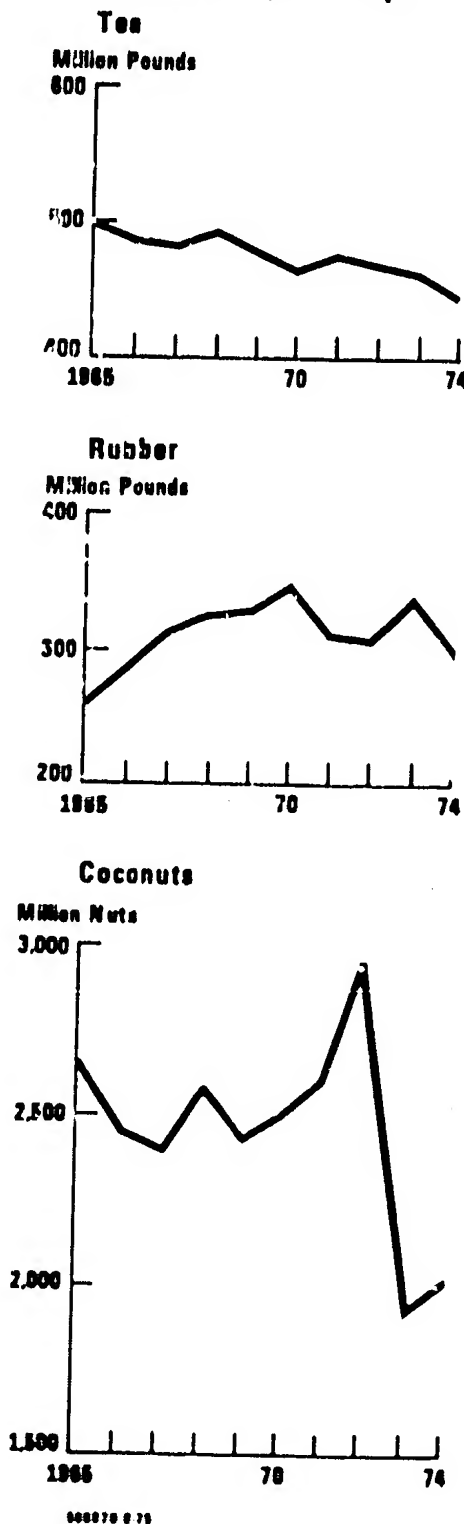
8. Government policies have hampered production in the tree crop sector.

- Heavy export taxes left over from the 1950s remain in effect, although depressed world prices have limited earnings since 1955. Moreover, since 1968, tea, rubber, and coconut exports have been denied the export bonus over the official exchange rate -- currently 65% -- provided to encourage nontraditional exports.

- Implementation of a 1964 agreement with New Delhi to repatriate stateless Tamil workers to India has disrupted the experienced labor force on tea and rubber plantations. The exchange rate system adopted in 1968 in part to help control trade deficits also requires payment of a 65% premium for imports of machinery and parts.

Figure 2

SRI LANKA: Production of Major Export Crops



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- The Business Acquisition Act of 1971 removed judicial recourse to challenge nationalizations. Redistribution of land under the 1972 Land Reform Law has transferred ownership of 20% of tea, 15% of rubber, and 10% of coconut acreage. Further nationalizations are currently under discussion.

9. The cumulative impact of these policies on producers has been to reduce investment in agriculture, particularly outlays to maintain and improve land and crops. Fertilizer consumption is falling (see Table 1). Investment in the replacement of old trees is declining (see Table 2). Current planting rates are far below levels needed to maintain tree crop production over the long term. In addition, the poor business climate is causing experienced managers to emigrate to plantations in Indonesia, Malaysia, and East Africa.

10. The steady growth in rice output achieved during the 1960s ended with the record harvest in 1970. Average annual growth in rice production of 6.1% between 1960 and 1970 consisted of a 3.6% growth in yields and a 2.4% growth in acreage. Improved varieties and increased fertilizer use, supported by enlarged credit facilities and active government research and extension services, raised yields. Acreage expanded because of double

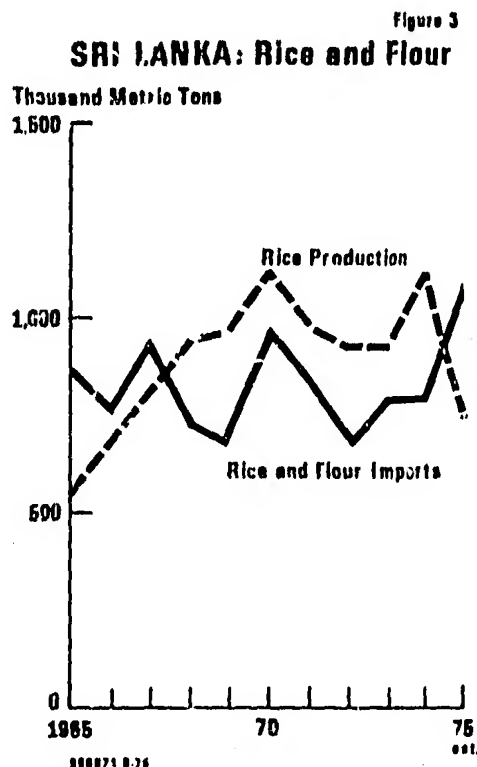


Table 1

Sri Lanka: Fertilizer Consumption
of Major Export Crops

	Thousand Nutrient Metric Tons		
	Tea	Rubber	Coconuts
1970	34.9	6.0	19.8
1971	33.4	4.2	18.4
1972	30.5	3.4	15.7
1973	24.3	3.9	11.6

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Table 2

Sri Lanka: Replanting of Export Crops and Total Acreage

Thousand Acres						
	Tea		Rubber		Coconuts	
	Replanted	Total Cultivated	Replanted	Total Cultivated	Replanted	Total Cultivated ¹
1970	6.9	597	10.2	569	24	1,150
1971	6.6	597	8.5	568	23	1,150
1972	6.4	598	8.7	567	19	1,150
1973	6.0	599	7.2	565	14	1,150
1974	4.3	598	7.1	563	13 ¹	1,150

1. Estimated.

cropping and the planting of new acreage. The rice production effort lost momentum after 1970. The 1971 insurrection and poor weather the following two years helped reduce output. Government credit for rice farmers steadily declined during these years as more farmers became ineligible for credit because of defaults on previous loans. Acreage planted contracted owing to both poor growing conditions and the increasing cost of bringing new acreage under cultivation.

11. Rapidly rising world food prices forced the government to return to its food production problem in late 1973. In September, Colombo launched a "Food War." The government raised its guaranteed procurement price 40% to try to keep up with increasing free market prices. Government loans for rice production in the major growing seasons were increased threefold through upward revisions in credit lines, and credit was reinstated to many in default. Offices responsible to the prime minister were opened in all 22 administrative districts to oversee local expenditures, identify production bottlenecks, and aid land reclamation. The prime minister and other top officials traveled the island exhorting farmers and local officials to increase production. These efforts paid off. Despite the late arrival of the monsoon rains, the winter 1974 harvest set

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a record, and a good summer harvest enabled 1974 rice production to nearly match the 1970 record.

12. While the "Food War" remains a top government priority, support to sustain the effort is flagging. Drought in late 1974 and early 1975 has reduced 1975 rice production to the lowest level since 1966. As a result of reinstated credit lines in 1973, many farmers felt no compunction to repay government loans, and 56% of rice loans for the record 1974 winter harvest were never repaid. Sri Lanka's complete reliance on imported chemical fertilizers makes it vulnerable to world market shortages. Construction of a urea plant to reduce this dependence, currently under consideration, will take several years. Government price policies, which have caused wasteful use of irrigation water, also have not been corrected.

Grain Distribution Problems

13. The government provides free weekly rice rations to everyone in the country except the 5% of the population who pay income taxes. This program has constituted both a serious drain on the economy's resources and a source of political instability since its inception in 1942. Widespread political discontent following attempts to reduce the subsidy in 1953 and 1962 caused the resignation of a prime minister and a finance minister. Following elections in 1970, Prime Minister Bandaranaike augmented the free weekly rice ration of 2 pounds per person with an additional 2 pounds at a subsidized price. Flour and sugar were also available through the government system.

14. The cost of government food distribution amounted to 14% of total government expenditures in 1973. The distribution system is supplied through government procurement of domestic rice and government imports of rice, wheat, and flour.

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15. Rapidly rising world food prices in 1973 and stagnant rice production forced the government to cut back its food distribution program. In February 1973 the subsidized price for the extra 2 pounds of rice was raised 60%, only to be cut by 12% in March. In June, flour prices were raised 26%. In October, as part of the Food War, the free rice ration was halved to 1 pound, the subsidized rice ration was eliminated, and flour was put on rationing at 1 pound per week at a 46% higher price. Most Ceylonese reacted calmly, realizing that domestic drought and high import prices necessitated these moves. Since 1973 the free rice ration has remained untouched, but the extra rice ration and the flour ration have been periodically cut and re-instated as the government attempted to adjust to fluctuations in supply. Cutbacks in subsidized food distribution have contributed to unprecedented malnutrition among the poorest 40% of the population.

Foreign Investment

16. Despite shortages of investment funds, influential leftists in the government have prevented nascent attempts to encourage private foreign investment. Investments in export-oriented light manufacturing, oil exploration, banking, and tourism are being held up until the government enacts legislation proposed in its 1972 White Paper on Private Foreign Investment. Action has been stalled by leftists who denounce foreign "exploitation" and advocate further nationalization. Their control over labor unions, which has been instrumental in preventing strikes in the face of austerity measures, gives them the clout to block new legislation.

17. The discouragement of foreign private investment has been particularly damaging in the search for domestic sources of petroleum. Sri Lanka relies totally on oil imports to supply the government-owned 39,000 barrel per day refinery near Colombo. Enquiries about oil exploration from Western oil firms have been consistently turned down. Private foreign oil has an odious reputation with leftist politicians. In the early 1960s,

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inadequate compensation to US oil companies for nationalized properties led to a brief cutoff of US aid under the Hickenlooper Amendment.

18. Sri Lanka turned to the USSR for help in oil exploration in 1972. The Soviets surveyed both onshore and offshore areas, but were willing to drill only onshore. The first exploratory well was inaugurated in February 1974, but only traces of oil and gas were found. Further test wells are being pursued. When it became apparent that offshore drilling would be necessary, Sri Lanka reluctantly turned to Western firms. Still wary of foreign investment, the government is hiring drilling services on a contract basis.

Foreign Trade and Payments

19. Despite continuing deficits in its international accounts, the government has staved off severe financial crises through rigorous import and foreign exchange controls. Food imports have been given priority, forcing curtailment of imports of other raw materials and capital goods.

20. A \$135 million deterioration in Sri Lanka's current account deficit in 1974 mainly reflects higher world commodity prices. Export growth of 28% was surpassed by the 66% growth in imports (see Table 3). Food imports rose \$126 million despite little increase in grain import volume and a 78% decline in sugar import volume. Although petroleum imports increased \$92 million on 13% lower volume, higher earnings from product exports, largely bunkers, offset 35% of the increased cost. The value of tea and rubber exports went up while their volumes declined by 15% and 20%, respectively. The value of coconut product exports more than doubled on higher volume.

21. Sri Lanka relied heavily on foreign aid and short-term capital inflows to finance the 1974 current account deficit of \$173 million (see Table 4). Net aid inflows jumped from \$37 million in 1973 to \$109 million in 1974. The largest inflows were from the IMF through the Oil Facility

Table 3

Sri Lanka: Foreign Trade¹

	Million US \$	
	1973	1974
Imports	431	717
Food	215	341
Petroleum	46	138
Fertilizer	17	33
Other	153	205
Exports	411	527
Tea	197	205
Rubber	92	111
Coconut products	35	81
Petroleum products	21	53
Gems	24	20
Other	42	57
Trade balance	-20	-190

1. Data are on an arrivals and departure basis.

and from China -- \$41 million and \$22 million, respectively. The government increased its dependence on foreign short-term credits in 1974 rather than cut the volume of imports back even further. The increased short-term indebtedness and the relatively hard terms of the IMF Oil Facility (repayment in seven years at 7% interest) have heightened the potential for serious repayment problems in the coming years.

Prospects

22. This year, Colombo will have to obtain foreign funds to finance a current account deficit in the neighborhood of \$200 million. Lower domestic rice harvests in 1975 will sharply raise grain import volume, but the value should grow less because of lower prices. Continuing strength in tea prices in 1975 should offset volume declines. Coconut and rubber

Table 4

Sri Lanka:
Balance of Payments¹

	Million US \$	
	1973	1974
Trade balance	-47	-185
Services and private transfers (net)	9	12
Current account balance	-38	-173
Economic assistance (net)	37	109
Inflows of aid	87	160
Repayment of debt	-50	-51
Long-term private capital (net)	1
Short-term private capital (net)	27	42
Inflows	159	193
Repayments	-132	-151
Other capital, errors and omissions	-9	12
Capital account flows	55	164
Changes in official reserves	17	-9
Official reserve level (end of year)	87	78

1. Data are on a payment basis.

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exports will decline because of lower world prices and production problems. The government will limit the trade deficit to keep it in line with available financing by controlling nonfood imports. Aid inflows in 1975 will increase sharply because of an expanded IMF Oil Facility; \$140 million in aid from oil producers in 1974, which was largely unused; and a \$32.5 million aid commitment from the United States. The government is also likely to seek some short-term loans to meet the situation.

23. Sri Lanka's longer term growth prospects are bleak. Output from the major tree crops is not likely to reach previous record levels in the next few years, because the government gives no indication that it is going to alter its detrimental production policies. Rice production, however, could increase somewhat if recent government efforts to grow more food are pursued.

24. During the next two years, attention will be diverted from measures to generate economic growth, as Sri Lanka hosts the 1976 nonaligned conference and holds national elections, required before mid-1977. Further reductions in consumption will be studiously avoided, particularly while the opposition is making wild electioneering promises of more consumer goods at lower prices. As a result, every effort will be made to create the appearance of economic success and to increase consumption prior to the elections. As part of this effort, Colombo will increasingly turn to short-term borrowing abroad. These developments will contribute little toward solving Sri Lanka's production and unemployment problems. They raise the potential for sharp consumption cutbacks after election day, which, when combined with continuing widespread unemployment, could easily lead to political instability.

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